Exhibit ___ (KLE-1T)
Docket No. UG-041515
Witness: Kenneth L. Elgin

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, **Complainant,** **v.** **AVISTA CORPORATION, d/b/a AVISTA UTILITIES,** **Respondent.**	**DOCKET NO. UG-041515**

TESTIMONY OF
KENNETH L. ELGIN

STAFF OF THE
WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION

October 15, 2004

Q. Please state your name and business address.

A. My name is Kenneth L. Elgin. My business address is Chandler Plaza Building, 1300 South Evergreen Park Drive SW, Olympia, Washington, 98504-7250.

Q. By whom are you employed and in what capacity?

A. I am employed by the Commission's Regulatory Services Division as its Case Strategist.

Q. Have you prepared an exhibit describing your education and relevant employment experience in public utility regulation?

A. Yes. It's Exhibit ____(KLE-2).

Q. Would you please explain your assignment in this Docket.

A. My assignment is to review the Company's case, identify the major issues that require resolution and determine how best to proceed with Staff's analysis of the Company's request for higher rates. I will provide a summary of Staff's proposal for processing this case, and the underlying reasons for recommending the settlement be accepted in this case.

Q. Please explain Staff's proposal for processing this case and the basis for the proposed settlement in this proceeding.

A. Staff's recommendation continues to rely upon utility cost of service as the basis for determining rates. Its proposal measures the Company's financial performance using a historical test period in order to answer the question whether the Company has a revenue deficiency. If the Company has a revenue deficiency, it is entitled to new rates that meet the requirements of RCW 80.28.010 (1).

Q. Please explain the Commission's policy for measuring the Company's revenue requirements.

A. The Commission's traditional practice is to measure a utility's revenue requirements on the basis of a historical test period analysis with a fully restated *pro forma* results of operations. This is commonly referred to as rate base rate of return regulation. WAC 480-07-500 through -550 describes the information the utility must present to the Commission so that it may determine whether rates are consistent with the statutory direction under Chapter 80.28 RCW. RCW 80.04.130 provides that the Commission must take no longer than ten months to make its decision to determine whether rates meet the statutory standard under RCW

80.28.010. The maximum suspension period under RCW 80.04.130 protects the interests of the utility seeking compensatory rates from undue delay in processing applications for new rates.

Q. Please summarize what you believe to be the specific facts and circumstances of this case and why a ten-month suspension period is unnecessary.

A. The following is a list of specific factors involved in this rate case, all of which I will discuss more fully in my testimony:

- The Company has been experiencing inadequate per book returns in its gas operations for a sustained period;
- Staff performed an audit of the Company's books;
- Avista accepted all Staff adjustments from the audit;
- Avista agrees to present no *pro forma* adjustments;
- Avista accepts a rate of return that Staff would present in litigation;
- The proposed rate spread and rate design are consistent with prior practice;
- The lack of complex issues in the case needing resolution; and

- The resolution of this general rate case synchronizes the rate change with the Company's expected changes in its PGA filing, Docket No. UG-041786.

First, the Company has been reporting low per book rates of return from its Washington gas operations for the past two years. Exhibit ____ (KLE-3) shows these per book returns for Avista's Washington gas operations. Since January 2003, Avista's highest reported return on rate base for its Washington gas operations was 5.45%. In light of these low per book returns, and a review of the Company's testimony and exhibits filed pursuant to the Commission's rules, I believe the Company has demonstrated that it is entitled to increased rates now. Staff does not believe that under the present circumstances a full ten-month suspension period is necessary or warranted. The more critical question to answer now is how should Staff proceed with determining Avista's revenue deficiency.

Q. Please explain the underlying reasons for Staff's support of the proposed settlement.

A. The process Staff is recommending embraces the traditional concept of measuring utility cost of service and calculating a revenue deficiency based upon a fair rate of return on rate base. The only questions are whether there has been an adequate review of the Company's financial performance, and if new rates are justified, how much additional revenue should the new rates produce.

In this case Staff has completed its review of the Company's financial results from its Washington gas operations. Staff is recommending rates which adequately compensate the Company for providing natural gas service to customers in Washington.

Q. Are you aware of any other circumstances in which the Commission exercised its authority under Chapter 80.28 RCW and determined that a public service company is entitled to new rates without conducting a full hearing process, and without using the entire ten months that the legislature authorized for Commission action on a proposed change in rates?

A. Yes. Pursuant to Chapter 80.28 RCW, the Commission regularly reviews rate applications for water companies without a full evidentiary hearing. These cases are often processed without a full hearing schedule, and the Commission takes substantially less than the entire ten months provided by the legislature to process a request to change rates. The Commission has considerable discretion to exercise its authority when determining how to evaluate any rate request, but in no circumstance may it take more than ten months to fully adjudicate any general rate request. The ten-month suspension period is a maximum, not a minimum allowable time to review requests to modify tariffs.

Q. Are there any complex issues presented by Avista in its case?

A. No. There are no complex issues requiring resolution in this case. For example, there are no issues on interstate cost allocations, no issues involving allocations between services, no prudence review for new resources and, most significantly, the Company is accepting Staff's recommendation for rate of return. If there were complex issues, Staff would not be advocating the settlement in this case.

Q. Are there any other examples in which the Commission has determined that a utility is entitled to rate relief without having a full ten-month statutory suspension period?

A. Yes. Puget Sound Energy's Purchased Cost Adjustment mechanism for its electric operations is another example. Within that mechanism is the opportunity for Puget Sound Energy to file a Power Cost Only Rate Case.

It is a much more complex process than the present case, and all interested parties have agreed to use their best efforts to process it within four months.

Q. Is it unfair to customers for the Commission to act on a company's rate request before the statutory period has expired, given that this causes customers to begin paying the higher rates sooner?

A. No. Customers do not have a right to regulatory lag, just as the regulated company does not have a right to immediate rate relief. Within the statutory time constraints – no retroactive rate making and no suspensions beyond ten months – the Commission should take as much time as the circumstances require to decide the reasonableness of any particular rate request.

Q. Please explain how you have approached the measurement of the Company's revenue requirement in this case.

A. The recommendation is for the Commission to determine revenue requirements for Avista's Washington gas operations based upon what is called a "commission basis" report.

Q. Please explain the "commission basis" report.

A. Under WAC 480-90-208 (2) the Commission requires all gas utilities to file normalized annual financial reports. This financial report, while not a fully restated *pro forma* financial statement, is a statement of the Company's financial performance under normal operating conditions. It is sufficient to accurately portray a utility's financial performance. While *pro forma* adjustments to the historical test period are often the most controversial and discretionary part of a rate case, the utility is not required to propose any such adjustments at all. In the present case, Staff is of the opinion that Avista's "commission basis" financial report is sufficient to determine revenue requirements for its Washington gas operations , and it may be relied upon by the Commission to determine revenue requirements for rate making purposes.

Q. Please explain how the "commission basis" report fits into the Commission's traditional measurement of historical test period results for rate making purposes.

A. The "commission basis" report is a statement depicting a utility's financial performance based upon normalized operating conditions. (Electric companies filing requirement are identical in Chapter 480-100 WAC.) In the traditional rate making process, utilities first present an actual historical test period financial statement of its business. This "per books" result is then normalized or restated. Restating adjustments adjust the historical test period for normal events and include all adjustments previously ordered by the Commission for a specific utility. Once the restated operations are complete, the Company then may present its proposed *pro forma* adjustments to the restated historical test year results. In this sense, the per books results as adjusted to normalized results, i.e. "commission basis," is the foundation for the Commission's traditional rate making process. *Pro forma* adjustments are not required. Therefore, I believe it is reasonable in some circumstances, such as this where a utility has been reporting low per book returns, to use the "commission basis" report for a factual determination of revenue deficiency.

Q. Did Avista present a restated or Commission basis analysis in its direct case to support its request for rates?

A. Yes. The Company's restatement is presented by Mr. Falkner in Exhibit____(DMF-2), page 7, column titled "restated total".

Q. Please explain the remainder of the information in Mr. Falkner's Exhibit____ (DMF-2, pages 8-91).

A. Pages 8 and 9 of this exhibit present *pro forma* adjustments to the test period. As noted earlier, Avista agreed to remove the *pro forma* adjustments in the determination of revenue requirements in the settlement agreement, except for adjustment PF6 on page 8. Adjustment PF6 is actually a correction to the per books results of operations and is more properly classified as a restating adjustment. Avista agreed to include this item in the calculation of revenue requirements.

Q. What is the significant about the fact that no *pro forma* adjustments are being proposed?

A. Pro forma adjustments look at changes in cost of operations that will occur during the rate year. The standard for accepting these adjustments is that they must be known and measurable and not offset by other factors. As I already stated, these adjustments are the most difficult to analyze and almost always increase the utility's revenue requirement.

Q. Please continue with your discussion of Staff's analysis of Avista's revenue requirements.

A. Once a Company's restated results for the historical test period are measured and analyzed, a revenue deficiency may be calculated by measuring test period rate of return on the rate base produced by normalized operating income. The only thing necessary is to establish a fair rate of return to apply to the test period rate base.

Q. Did you use Avista's recommended rate of return on rate base to calculate revenue requirements in this case?

A. No.

Q. How did you then determine the appropriate rate of return to apply to rate base in order to determine the Company's revenue requirements?

A. I conducted an assessment to determine what I believe to be the appropriate return on equity for Avista and reasonable capitalization ratios for ratemaking purposes.

Q. Did Avista agree to use the capital structure and the return on equity you determined reasonable for purposes of this case?

A. Yes. These figures are what I could reasonably defend in a fully litigated proceeding.

Q. How did you go about determining a fair rate of return that should be applied to Avista's rate base for its Washington gas business?

A. The first step is the analysis of the Company's actual debt and equity ratios. The Company's actual equity ratio for the test period is reasonable only if some amount of short-term debt is included in the calculation. Including short-term debt in the calculation of a reasonable capital structure has traditionally been advocated by Staff in rate cases.

Next, I performed a study of the Company's return on equity requirements. In addition, I have been involved in the development of Staff's presentation of cost of capital in two contested energy proceedings currently pending with the Commission. This work formed the basis for my conclusion regarding a fair rate of return to apply to Avista's natural gas rate base in Washington.

Q. What is the basis for the agreement on rate of return for Avista's natural gas operations in Washington?

A. The settlement involves the Company's agreeing to an overall rate of return on rate base using the following principles: 1) a return on equity that Staff believed it could support in litigation; 2) Avista's actual cost of debt, including short-term debt; 3) Avista's actual cost of preferred equity; and 4) Avista's actual capital structure for the December 31, 2003 test period.

Q. What is the overall rate of return you are recommending for this proceeding based upon the calculation you just described?

A. I recommend a rate of return of 8.68 percent. Appendix A of the settlement agreement shows the 8.68 percent rate of return applied to the historical rate base of $131,916,000. The result is a net operating income ("NOI") requirement of $11,450,000. The test period NOI adjusted to the "commission basis" is $8,105,000. Therefore, the NOI deficiency is $3,345,000. Applying the NOI conversion factor to the NOI deficiency produces a revenue deficiency of $5,377,000. Staff recommends that the Commission adopt the settlement in order to provide new rates to cover this revenue deficiency. This recommendation is based upon the normalized results of operations using an overall rate of return on rate base that Staff believes is fair today.

Q. What increase did Avista present in its testimony and exhibits to this proceeding?

A. $8,635,000, or a 6.20% overall average increase.

Q. Has Staff had an opportunity to audit the Company's presentation of test period normalized results?

A. Yes. Staff conducted an audit of Avista's operations and concludes that Appendix A to the settlement agreement is a fair presentation of Avista's fully normalized gas operations in Washington.

Q. What are the settling parties' recommendations for rate spread and rate design?

A. For rate spread purposes the settling parties are recommending a uniform percentage of margin for each class. This rate spread moves all schedules towards their allocated cost of service. It should be noted that the rate spread proposal contained in the settlement has been used on numerous occasions and accepted previously by the Commission.

Appendix B, page 1, of the settlement agreement shows these calculations for each customer class. At the bottom of Page 1 of Appendix B, the spreadsheet shows the percentage increase in revenues for each class. The increases for each customer class presume the normalized gas costs in effect at the end of the test period.

For rate design, the settling parties agree to the increase in the basic charge for residential customers by $0.50 per month. Moving the customer charge to $5.50 is consistent with the margin increase for the class, and it would be the same as Puget Sound Energy's current customer charge. The energy rates are then increased to recover the remaining amounts assigned to residential customers. Appendix B, page 2, shows the rates the settling parties are proposing.

Q. Are there any other elements of rate spread or rate design that the settlement addresses?

A. Yes. Paragraph 10 of the settlement agreement addresses an issue related to the allocation of pipeline costs to transportation customers. The settlement reallocates some of these costs to sales service. This reallocation is similar to the methodology used for transportation service and sales service for other gas companies in the state.

Q. Are there any other elements of the settlement that you would like to explain?

A. Yes. The final element of the settlement is Appendix C. The traditional practice is for the Commission first to approve a settlement, following which, the utility makes a compliance filing to implement the terms of the settlement. In this instance, the settling parties are sponsoring the tariffs needed to implement the settlement and submitting them for approval as part of the settlement agreement. In doing so, the settling parties are requesting that the Commission's order accepting the settlement also accept the tariffs so that the rates may become effective November 1, 2004, to coincide with the rate changes necessary to reflect the Company's new cost of gas in its pending Purchased Gas Adjustment filing, Docket No. UG-041786. The November 1, 2004, implementation date is an essential element of the settlement agreement. In exchange for an earlier implementation date of the rates proposed in the settlement, Avista is foregoing its opportunity to advocate for the rates under suspension in this docket.

Q. Does this conclude your testimony is support of the settlement agreement?

A. Yes.